Further warnings on Chinese property markets

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For some time now, economists and financial analysts have been expressing concern over the state of the Chinese property market and whether the conditions have been created for a financial crisis. Now their voices have been joined by a leading Chinese property developer.

At a meeting of property developers and analysts last month, Mao Daqing, the deputy chief executive officer of Vanke, the largest Chinese developer, gave a frank assessment of the state of the market.

Mao believed that his remarks were off the record but his speech was leaked and has been the subject of a three-part report published on the Australian-based web site *Business Spectator*.

In its first instalment, headlined "What keeps China's biggest property developer up at night," *Business Spectator* noted: "According to Vanke's data, it will take more than 12 months to sell its existing inventory in 21 major cities and more than 24 months to clear stocks in other cities."

In what are known as third- and fourth-tier cities, the build-up of unsold real estate developments is even larger. According to Mao, in Tanhashan, a major steelmaking centre in the Hebei province, it will take Vanke more than 100 months to clear its entire inventory. He said Tangshan was a typical city in China's industrial belt, dominated by large state-owned industries such as steel, coal and cement. With the government moving to shut down these industries, and with little private investment to replace them, local government officials have increasingly come to rely on selling land in order to generate income.

While the more remote regions are showing signs of oversupply, the real estate frenzy is continuing in the major cities. This is not a sign of health, however, but more a fever chart of an impending crisis.

In his speech, Mao pointed out that at the peak of the Japanese real estate bubble, Tokyo's land value was about $4.3 trillion in 1990, equivalent to some 63 percent of United States Gross Domestic Product. When Hong Kong's real estate bubble collapsed in 1997, the total land value for the city was about $5.7 trillion, equivalent at that time to 66 percent of US GDP.

The collapse of the Japanese real estate bubble, at the beginning of the 1990s, saw the onset of the low growth and deflation that has characterised the Japanese economy over the past two decades.

According to Mao, Beijing's land value in 2012 was around $10 trillion, or 62 percent of US GDP. "Multiple pieces of evidence suggest that the Chinese property market in 2013 shared many of the characteristics with that of Japan and Hong Kong before the bursts of their asset bubbles," he said. The "housing construction frenzy" in China has reached its "highest peak in human history" over the past three years.

For cities that could attract new migrants it was safe to be building between 20 and 25 new units per thousand people, he said. But some so-called second tier cities were building at rates of between 30 and 40. These cities, mostly provincial capitals, account for almost one third of total construction in China.

Other analysts believe that the chief danger of a real estate collapse comes from the third- and fourth-tier cities. Whatever the differences over where the weakest point of the real estate market may be, however, there is growing agreement that a crisis is in the making.

Zhiwei Zhang, the China analyst for the Japanese finance house Nomura, has warned of a sharp market downturn, with the potential to bring about a severe decline in the rate of Chinese economic growth.

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A Nomura report issued last week stated: "To us, it is no longer of question of 'if' but rather 'how severe' the property market correction will be."

A rapid downturn will have far-reaching consequences because the property market accounts for 16 percent of China's GDP. Real estate accounted for 33 percent of fixed asset investment and 39 percent of government revenues in 2013.

"It's the most important sector in the economy, supporting growth and supporting government revenue," Zhang said.

Nomura's worst case scenario is that the government sticks with its current policies, based on tightening credit, and GDP growth falls to 6 percent, compared to the present rate of 7.4 percent.

Nomura's base case is that the government will "soon resort to more aggressive policy easing," thereby offsetting the slowdown in property investment. "However, more policy easing in the next few months will be critical, as the property correction could snowball."

The fears of a property slowdown, or even a crash, are not confined to Nomura. According to Credit Suisse analyst Dong Tao: "The Chinese property market does show signs of a bubble, in the form of prices being too high in tier-one cities and with inventory levels too high for lower tier cities."

Like Nomura, UBS, the Swiss global finance company, expects the Chinese government to step in to mitigate the effects of any major property downturn because such are the linkages between real estate and industrial sectors such as steel, cement and construction machinery, that any drop in construction would have a far bigger impact than declines in consumption.

However, notwithstanding its prediction that government authorities will intervene because of the importance of the real estate sector for the overall economy, UBS believes that "the risk of a sharper and more persistent property downturn has increased."

UBS has warned that local government finance would be significantly impacted by any property downturn, given that land sales have accounted for about a quarter of overall local government revenue in recent years. Furthermore, "there is a sizeable and growing risk" that government measures may not be able to stabilise the property market as developers aggressively cut their construction. This would aggravate difficulties for local governments and lead to a drop in demand for heavy industry products.

Accordingly, UBS warned there was a 15 percent probability that the property downturn could be "much more severe" than it "currently envisages," leading to a decline in the GDP growth rate to 5 percent by 2015.

Such an outcome would not only have a major impact on China but would rapidly flow on to economies throughout the region and around the world.

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